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Explanation on Opportunity Zones and Tax Credits

Within the Tax Cuts and Jobs Act of 2017[1] (the "Tax Reform Legislation"), was a provision that initially did not generate much interest and excitement, but it may be one of the most significant tax reform codifications that we have seen in decades. The Tax Reform Legislation established Opportunity Zones by way of a provision of the Internal Revenue Code, that being Section 140OZ-2 (the "OZ Rules")[2].

Pursuant to the OZ Rules, Treasury directed the individual states to designate certain census tracts as Opportunity Zones. These Opportunity Zones are areas that have been traditionally economically disadvantaged areas and have not experienced the growth that has benefited certain parts of our country since the end of the 2008 recession. The hope in creating these Opportunity Zones was that it would direct capital into those areas, thereby providing them with the resources needed to facilitate an economic revival. The way that the OZ Rules achieve this goal is to allow investors that have generated eligible gains from a capital event ("capital gains") to defer and possibly offset taxes on those capital gains by investing them in Opportunity Zones[3].

As mentioned above, the first step in the procedure was to have the individual States designate which census tracts they appoint as Opportunity Zones, which procedure the States completed as of June 14, 2018. Treasury approved those nominated census tracts as Opportunity Zones. On October 19, 2018, Treasury issued its first round of Regulations regarding Investing in Qualified Opportunity Funds[4] (a Qualified Opportunity Zone Fund is hereinafter referred to as a "QOF"). On April 23, 2019, the Treasury issued its second round of Regulations regarding Investing in QOF's[5], and on December 19, 2019 Treasury issued its final round of Regulations regarding Investing in QOF's[6] (the "Proposed Final Regulations").

Following the publication of the Proposed Final Regulations we now have a framework within which to work, which is as follows:

Assume that a taxpayer has a long-term capital gain, subject to the current 20% rate, plus the 3.8% add-on for the Affordable Care Act, for a total of 23.8%. To benefit from the OZ Rules, the capital gain would need to be invested into Opportunity Zone Property (i.e. real estate or a

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[1] H.R.1 – An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018. 115th Congress (2017-2018).

[2] 26 U.S. Code § 1400Z–2. Special rules for capital gains invested in opportunity zones.

[3] The gains that the OZ Rules apply to are "eligible gains" that are treated as capital for tax purposes (prior to January 1. 2027), and that are not generated from sale or exchange with a "related" party, i.e. a 20% direct or indirect relationship between the parties (either before or after the sale/exchange).

[4] 26 CFR Part I, REG-115420-18.

[5] 26 CFR Part I, REG-120186-18, RIN 1545-BP04.

[6] 26 CFR Part 1 TD 9889 RIN 1545-BP04.

business - hereinafter referred to as "OZ Property") within 180 days of realizing the capital gain. OZ Property must be (i) tangible property that is used in a "trade or business"; (b) property that was purchased from an unrelated[7] party after December 31, 2017; and (c) that the original use of the property must begin with the QOF or the underlying OZ Business (the "original use requirement"), unless the QOF or underlying OZ Business "substantially improves" the OZ Property, which means that the QOF must invest at least 100% of the adjusted tax basis of the OZ Property into the OZ Property within 30-months of the acquisition of the OZ Property[8].

If the capital gain is invested into a QOF within 180 days, the QOF then has 180 days to invest into OZ Property. A QOF can be an entity, such as, but not limited to, a corporation, LLC, partnership, or limited partnership. If a partnership or an S Corporation realizes gain but elects not to defer that gain, instead allocating the gain to its owners, then the owners (partners, shareholders, or limited partners) can choose when to begin the 180-day reinvestment period. The Proposed Final Regulations allow the owners of a pass-through entity to begin the 180-day period on the last day of the entity's tax year, rather than on the date of the sale of the asset.

The QOF is able to self-certify on IRS Form 8996 when filing its first-year tax return. Once the initial election is made, the taxpayer may elect the deferral on IRS Form 8949 in order to elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.[9]

The QOF needs to have 90% of its assets invested in OZ Property, calculated as either the value or the cost of assets (the "90% test"). This 90% test, which is performed via a certification on Form 8996, measures the average of the QOF's holdings in OZ Property on the last day of the first 6-month period of the QOF's tax year and the last day of the QOF's tax year (the "test period"). The QOF is required to invest 90% of its assets in OZ Property during the test period. In terms of how you determine the value of an asset, it is either its value as reported on the QOF's financial statement or the cost of the asset to the QOF. In terms of tax credits, we use the cost of the tax credits to the QOF for purposes of the 90% test.

If a QOF invests in a business within an Opportunity Zone or operates a business through a subsidiary, the test for determining whether the business qualifies as OZ Property is that it needs to have "substantially all" of its assets within an Opportunity Zone. The Regulations state that "substantially all" of its assets means 70% of its assets.[10]

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[7] Owners of 20% or less of QOF/QOZB (including capital and promotes) or 30% or less of the total asset mix.

[8] The substantial improvement requirement is applicable to building improvements and not the land itself. Also, the QOF can meet the substantial improvement test by purchasing other property that satisfies the original use test if the new property improves the functionality of the property being improved.

[9] The taxpayer's basis in the QOF investment is initially zero. Once the taxpayer has held the QOF investment for 5-years, the basis of the QOF investment is increased to 10%, thereby allowing for the taxpayer to disregard 10% of the original capital gain. If the taxpayer holds the QOF investment for at least 10-years, the basis of the QOF investment is increased to 100% of the fair market value of the QOF interest, i.e. its sale price. This results in there being no tax due on the gain attributable to the QOF investment. The taxpayer must defer the capital gain using Form 8949 and then elect to increase the basis upon sale of the QOF interest using the same form.

[10] The subsidiary or OZ Business must meet the definition of an Opportunity Zone Business and then must satisfy a "70% test", an "income and assets test", and a "qualifying business" test. The "70% test" is satisfied if 70% of the tangible property owned by the OZ Business is OZ Property. The income and assets test requires that (a) 50% of the

A QOF can make either a direct investment (QOF owns the OZ Property) or an indirect investment (QOF owns stock or a partnership interest in an entity that owns the OZ Property) into OZ Property. For an indirect investment the OZ Property must actively generate income, i.e. > 50% of income must be generated in the Opportunity Zone. Note that triple-net-leases are not considered active income generators.

Accordingly, assume the capital gain is invested into a QOF, and that the QOF then invests in OZ Property, so that the "substantially all" test is met. The taxpayer will elect to defer the capital gain and pay no taxes on said gain. The taxpayer would have to pay 90% of the capital gains taxes by 12/31/2026.

There is an additional benefit as well, in that if the taxpayer holds the OZ Property for *10 years*, i.e. until 12/31/2030, *all appreciation on the asset will be tax-free*. Assume that a $1,000,000 invested in the QOF was valued at $1.4 million when sold in 12/31/2030, then the $400,000 in appreciation would be tax free.

There are several additional points to note:

(a) The taxes are only deferred until 12/31/2026, regardless of whether the OZ Property is sold. By way of example, in order to get the tax-free appreciation, the investment must be held until 12/31/2030, but taxes are due at 12/31/2026, so the taxpayer needs to ensure sufficient additional capital to pay the taxes at that time;

(b) The Regulations correct an apparent timing issue, in that (i) the Opportunity Zone designation per statute will expire on 12/31/2028; (ii) a taxpayer must hold the OZ Property for 10 years from the date the investment is made to achieve the 100% basis step-up; and (iii) the taxes are deferred only until 12/31/2026. The Regulations correct this imbalance as follows: Because the latest date for which a taxpayer may generate a capital gain is 12/31/2026, and a taxpayer would then have 180 days to invest that gain in a QOF, i.e. by June 30, 2027, and the QOF would then have 180 days to invest the funds into OZ property, i.e. December 31, 2027 -- the 10 year hold would then run until 12/31/2037, and the Regulations allow another 10 years to dispose of the investment. Therefore, the taxpayer would have until 12/31/2047 to make the step-up basis election;

(c) To me, one of the more interesting clarifications in the Proposed Final Regulations is the use of the term “treated as capital gain” because this allows for a gain from the sale of a Sec. 1231 asset, which by definition is not a capital asset, to qualify as a capital gain. A 1231 gain is a gain from the sale/exchange of real or depreciable property used in a trade or business and held for over one (1) year. 1231 assets include buildings, machinery, land, timber, and other natural resources, unharvested crops, cattle, livestock, and leaseholds.

(d) The other important takeaway from the Proposed Final Regulations, is one that is particularly important to me as a tax credit professional, particularly regarding solar energy installations. That

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gross income of the OZ Business be derived from active conduct of trade or business in the OZ, which is achieved by: [(i) 50% or more of hours spent by employees be within OZ (ii) 50% or more of payments to employees are for services within the OZ, or (iii) 50% of the management/operation of the OZ property is within the OZ, AND a substantial portion of the intangible property must be used in the active conduct of trade or business in the OZ], and (b) less than 5% of the assets are nonqualified financial property (debt (term of more than 18 months), stock, partnership interests, options, futures, forward contracts, warrants, notional principal contracts, annuities). The disqualified business test is that the OZ Business cannot own a sin business, i.e. a golf course, Country Club, massage parlor, hot tub or suntan facility, racetrack or other gambling facility, or an alcoholic beverage store.

Regulatory clarification deals with the exclusion from gain on the sale of a QOF interest held longer than 10 years. This exclusion is the most important provision of the OZ Rules in that, as more fully explained below if the investment in the QOF is retained for at least 10 years, there will be no gain recognized upon a sale of the QOF interest. The Proposed Final Regulations expand the scope of that exclusion to sales of assets by the QOF ***and*** a Qualified Opportunity Zone Business ("QOZB"). This means that ordinary income (such as depreciation recapture) from the sale of an asset will be protected under the exclusion.

Finally, that there are 2 important distinctions for Opportunity Zone investments versus 1031 like-kind exchanges, i.e. (1) The capital gains can be invested in OZ "property" which does not have to be of a like-kind to the asset sold; and (2) The original basis of the asset does not have to be invested in the OZ Property (as it does in a 1031 like-kind exchange); and the taxpayer can invest up to the whole capital gain, but does not have to invest the entire gain.

Tax Credits Overview

The Federal Historic Preservation Tax Incentives program, which is one of the nation's most successful and cost-effective community revitalization programs to date, encourages private sector rehabilitation of historic buildings by offering tax credits on qualified remediation expenses (QRE's). The QRE's that are tax credit eligible are established in regulations promulgated by the National Park Service (NPS).

As a federal authority, the NPS administers the historic tax credit, which amounts to 20% of the QRE's in a certified rehabilitation project.

For a project to qualify for historic tax credits, it must be an income producing property listed on the historic register; located in a historic neighborhood; or be eligible for listing on the historic register.

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The Low-Income Housing Tax Credit ("LIHTC") is a federal subsidy program that was created by the Tax Reform Act of 1986, and is the most important resource for creating affordable housing in the United States today. The LIHTC program gives State and local LIHTC-allocating agencies the equivalent of nearly $8 billion in annual budget authority to issue tax credits for the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households.

The aim of the LIHTC is to provide incentives for the development of housing for low-income individuals in every state. This is achieved by granting tax credits to developers, which they can sell to investors. The LIHTC program requires the joint efforts of the Internal Revenue Service (IRS), the Department of Housing and Urban Development (HUD), and agencies from each state. The LIHTC database, created by HUD and available to the public since 1997, indicates that 46,554 projects and 3.05 million housing units have been placed in service between 1987 and 2016 using the LIHTC program.

Benefits of Tax Credit Investing

Investing in federal and state historic tax credits provides investors with the ability to offset income tax liabilities on passive revenue streams, via purchasing these tax credits at a discount to par value, yet still recognizing the 100% par value of these tax credits towards their income tax liability. Certain tax credit investments also spin off generous depreciation benefits to investors.